

## **EMPLOYEES' RETIREMENT SYSTEM OF THE COUNTY OF MILWAUKEE**

### **MINUTES OF THE FEBRUARY 20, 2008 ANNUAL PENSION BOARD MEETING**

1. Call to Order

Chairman Dean Roepke called the meeting to order at 9:30 a.m. in the Bradley Pavilion of the Marcus Center, 929 North Water Street, Milwaukee, Wisconsin 53202.

2. Roll Call

Members Present:

Linda Bedford  
Donald Cohen  
Marilyn Mayr  
John Parish  
Dr. Sarah Peck  
Dr. Dean Roepke (Chairman)

Members Excused:

Jeffrey Mawicke  
Thomas Weber (Vice Chairman)

Others Present:

David Arena, Director of Employee Benefits, Department of Administrative Services  
Mark Grady, Principal Assistant Corporation Counsel  
Gerald J. Schroeder, Interim ERS Manager  
Vivian Aikin, ERS Administrative Specialist  
Bob Shupe, ERS Administrative Specialist  
Steven Huff, Reinhart Boerner Van Deuren s.c.  
Kristin Finney-Cooke, Mercer Investment Consulting  
Terry Dennison, Mercer Investment Consulting  
Craig Dean, Loomis Sayles & Company, L.P.  
Robert S. McManama, Loomis Sayles & Company, L.P.  
Milwaukee County Retirees and other attendees

3. Chairman's Report

The Chairman welcomed all those attending the annual Pension Board meeting. He stated that the meeting agenda and additional handouts are available at the table outside the meeting room. He reported that Ms. Mayr has booked the Zoofari Conference Center for next year's annual meeting. He then provided an overview of the contents of the agenda.

4. ERS Fund Results and Update – Kristin Finney-Cooke, Mercer Investment Consulting

Ms. Finney-Cooke presented an ERS performance evaluation report covering 2003 through 2007. She indicated that she will review ERS's 2007 and historical performance, the overall market performance by asset class, ERS's current asset allocation, the investment decisions made by the Pension Board in 2007, investment changes made to ERS in 2007 and ERS's 2008 strategic initiatives.

Ms. Finney-Cooke reviewed ERS's performance compared against the Total Fund Composite Market Index, which is a benchmark that is comprised of benchmarks for different asset classes and the benchmarks are weighted according to the composition of a typical diversified pension fund. She stated that ERS had a 6.3% rate of return in 2007, which was .3% better than the Total Fund Composite Market Index. She stated that ERS achieved the .3% excess return over the Total Fund Composite Market Index by having its portfolio actively managed. She reported that ERS outperformed the Total Fund Composite Market Index for the two, three and five year periods and that ERS's outperformance relative to the benchmark increases as the time period lengthens. As an example, she indicated that over the five year period, ERS has a rate of return of 13.5%, while the benchmark returned 12.6%. She stated that ERS has performed well despite having a very conservative portfolio.

Ms. Finney-Cooke discussed the overall capital market returns for 2007, as well as the preceding three and five year periods. She noted that in 2007, the small cap market and real estate investments both performed poorly, even though both of these categories performed well over the three and five year periods.

Ms. Finney-Cooke reviewed the performance of the domestic equity market. She reported that the S&P 500 gained 5.5% in 2007, while the Russell 2000 Index lost 1.6%. She noted that in 2007, growth outperformed value in all of the capitalization levels, while value outperformed growth over the three and five year periods. She stated that in 2007 large cap domestic equities outperformed small cap domestic equities. She pointed out that a well-balanced portfolio must contain domestic equities, international equities, a fixed income component and real estate.

Ms. Finney-Cooke summarized the performance of international equities markets. She indicated that international equities posted strong returns in 2007, with the Broad MSCI EAFE Index returning 11.6% and emerging

markets returning 39.8%. She stated that growth outpaced value in the international equities markets in 2007.

Ms. Finney-Cooke discussed the 2007 performance of the fixed income market. She reported that the Lehman Brothers Aggregate Bond Index gained 7% and the Lehman Brothers Long Government/Credit Index posted a 6.6% gain. She indicated that there was a flight to quality in late 2007, which increased the 2007 fixed income returns. She explained how the subprime mortgage problems affect the fixed income market.

Ms. Finney-Cooke summarized ERS's asset allocation as of December 31, 2007 and discussed how it compares to ERS's asset allocation policy. She indicated that a strategic asset allocation study compares the fund's needs against its long-term objectives. She stated that a strategic asset allocation review must be performed every three to five years. She reported that ERS is currently working on a strategic asset allocation review, which is anticipated to be completed by the end of 2008 or the beginning of 2009. She noted that ERS has 31% of its portfolio in domestic equities, 20% in international equities, 42% in fixed income, 2% in venture capital, 3% in real estate and the remainder in cash. She specified whether ERS is under or overweighted in the various asset classes. She indicated that ERS is within 1% of its asset allocation policy for all asset classes.

Ms. Finney-Cooke reviewed the investment decisions made by the Pension Board and the changes that were made to the ERS portfolio in 2007. She stated that Capital Guardian, ERS's large cap international equity manager, was terminated due to concerns over poor performance. She noted that after an intensive due diligence process, Baring Asset Management was chosen to replace Capital Guardian. She also reported that Hotchkis & Wiley was terminated as ERS's mid cap value equity investment manager due to its poor performance. She explained that the assets managed by Hotchkis & Wiley were transferred temporarily to the iShares Russell Mid Cap value Index ETF. She summarized the Pension Board's due diligence process to replace Hotchkis & Wiley and pointed out that Artisan Partners and WEDGE Capital Management have been chosen as finalists. She indicated that the Pension Board rebalanced the ERS portfolio by transferring additional assets to fixed income investments from equities. She also noted that the Pension Board rebalanced its mid cap equity investments. She stated that ERS's real estate investment manager's guidelines are in the process of being changed from a domestic to an international real estate investment trust.

She reported that ERS had \$1.606 billion in assets as of December 31, 2007, which represents a decrease from the \$1.621 billion at the end of

2006. She compared the fund's three and five year performance numbers against ERS's fund universe and noted that ERS ranked slightly below its peer group. She pointed out that the comparison numbers are not necessarily equal because ERS may have a more conservative portfolio than the other funds in its universe, which may not result in showing ERS's true comparative performance. She then discussed ERS's 2008 strategic initiatives.

5. Emerging Investment Industry Trends – Terry Dennison, Mercer Investment Consulting

Mr. Dennison described 2008 investment industry trends and their impact on Milwaukee County. He indicated that his presentation will explain what is occurring in the market, how the current market environment affects ERS, what other pension plans are doing in response and what ERS could possibly do to improve its performance. He stated that many funds are focusing on risk management to protect their assets in the current volatile market environment. He discussed some of the new products and investment strategies in the investment industry that have been created and used to produce superior returns. He noted that the market is becoming more of a global market and that global investing is becoming the common practice among investors. He pointed out that some domestic household brands, such as McDonald's, derive a significant portion of their revenues from outside the U.S., while many non-U.S. multinational companies compete in the U.S. He indicated that most investment management research companies no longer distinguish between the U.S. and non-U.S. companies, which has resulted in emerging markets investments becoming mainstream investment opportunities.

Mr. Dennison discussed the history of investing in international markets. He stated that previously there were many concerns, including political instability and foreign currency risk, which have been alleviated due to the strength of international currency and the establishment of currency hedging. He indicated that growth is more rapid in international markets than domestic markets. He noted that many countries, including Russia and China, have strong currency reserves.

Mr. Dennison suggested that there is a possibility that equities may be on the decline in the future. He noted that the markets may be affected because baby boomers will be spending wealth instead of accumulating wealth. He stated that a large amount of wealth is being transferred to more consumption-oriented generations. He reported that there is less demand for equities in participant directed retirement programs than in defined benefit plans.

Mr. Dennison explained the emerging practice of liability driven investing for corporate plans. He stated that corporate plans have a strong incentive to match liabilities with assets because of the accounting treatment of pension plans. He noted that matching requires a movement from equities to bonds, which ultimately reduces the volatility of corporate pension plans. He indicated that the accounting treatment of pensions is driving the movement towards bonds. He pointed out that the practices of corporate plans may decrease the demand for equities in the future, which would result in a reduction of returns on equities.

Mr. Dennison discussed the factors that led to a change in markets in the summer of 2007. He reviewed the market's performance between 2002 and 2007, noting that the central bank policy provided stable, low inflationary growth, the credit market liquidity was very high, the volatility in the stock market was historically low and the credit spreads in the bond market were low. He pointed out that periods of volatility are not necessarily bad because they allow active investment managers to find better values and increase a fund's return. He indicated that the market conditions led investors to ignore risk, such as inflation, and people had the mindset that the market environment was different this time. He stated that investors began using more aggressive strategies and investing in more volatile securities. He noted that the recent market environment has changed investors' perception of risk. He stated that the equity markets have become very volatile and there may be a movement away from aggressive management techniques, complex securities and risky investment practices as a result.

Mr. Dennison indicated that actuaries have estimated to him that only \$.20 per benefit dollar represents contributions, while the other \$.80 represents investment earnings. He stated that a fund cannot utilize an ultra conservative investment strategy because the fund would not otherwise earn a high enough rate of return that would prevent the fund from paying out more benefits than money it takes in or earns. He explained that funds will need to implement a more advanced approach to return and risk in order to achieve their required rates of returns while minimizing risk. He noted that a fund will need to develop a balance between its desired rate of return and its tolerance for risk. He stated that the first question in any asset allocation study is how much risk a fund is willing to take. He discussed how asset allocation models are sensitive to the price fluctuations of stocks and bonds. He opined that it will be harder to achieve returns in the next five years as it was during the past five years. He suggested that funds will need to find new asset classes to produce their required rate of returns.

Mr. Dennison predicted that the portfolio structures and management techniques will be as different from today in five years as the techniques today are from 30 years ago. He stated that the Pension Board has done a good job producing returns that exceeded the benchmarks even though ERS has a conservative asset allocation strategy. He noted that ERS does not need to become more aggressive in its strategies, but it may need to become more innovative in achieving its returns.

Mr. Dennison explained the historical approaches used in investment portfolios. He indicated that funds have used passive strategies to achieve near market returns for the large cap domestic equity and fixed income asset classes. He stated that alpha is a measure of what the manager added or subtracted from the benchmark. He explained how alpha optimization strategies are very sophisticated and try to maximize gains while minimizing losses. He pointed out that active managers try to exceed the benchmark. He noted that if there are too many investment managers who are benchmark conscious, the result is an expensive index fund. He stated that the current way diversified portfolios are constructed prevents situations where all investments decline in value at the same time, but also prevents situations where all investments perform well simultaneously. He stated that a decision to seek alpha is made based on a critical assessment of the likelihood of winning and whether the magnitude of a win is sufficient to balance the corresponding costs and risks.

Mr. Dennison stated that Mercer is experimenting with a concept called dynamic asset allocation, which tries to achieve the maximum rate of return given a certain risk tolerance by focusing on small quarterly or annual reallocations among asset classes with abnormal valuations. He explained another approach named dynamic manager management, which calls for lowering the asset allocation to insignificant levels for managers that are underperforming and giving better performing managers an increased asset allocation. He noted that most funds choose managers who have done well over a three year period but he explained that most managers only do well for a three year period.

Mr. Dennison reviewed the concept of beta, which represents an investment's expected sensitivity to the market. A beta of 1.0 means that the investment is expected to move with the market, while a beta higher than 1.0 means an investment is riskier than the market and a beta less than 1.0 means the investment is less risky than the market. He discussed potential new sources of beta, which do not require financial engineering. He indicated that commodities, such as agriculture and energy, are a growing area for a source of beta. He noted that positions in undervalued

currencies or investments in infrastructure, such as toll roads, could provide sources of beta. He pointed out that emerging technologies, such as new solar energy, and European credit fixed income are other potential sources of beta. He explained that the new sources of beta may do a better job of matching the fund's income with its benefit payments.

Mr. Dennison reviewed the definition of alpha, which is the measure of a portfolio's excess market return on a risk adjusted basis. A positive alpha indicates that an investment manager contributed to a portfolio's rate of return through security selection, while a negative alpha means the investment manager detracted from the portfolio's performance. He explained why some sources of alpha did not perform. He stated that distressed debt funds could be a potential new source of alpha. He suggested that funds should invest 5% to 10% of their assets in these types of opportunistic investments. He cautioned that these investments are only open for a short period of time and will have no benchmarks other than the investment manager's track record.

6. Fixed Income Portfolio and the Bond Market – Robert McManama and Craig Dean, Loomis Sayles & Company, L.P.

Mr. Dean introduced himself and Mr. McManama as representing Loomis Sayles & Company, L.P. ("Loomis"), which is headquartered in Boston. He stated that Loomis is well known for its fixed income investment management. He reported that Loomis was founded in 1926 and manages investments in both global and domestic bonds and equities. He indicated that Loomis manages over \$130 billion in assets, of which \$100 billion is invested in fixed income investments. He explained how Loomis is dedicated to investment research with a staff of over 50 full time researchers. He pointed out that Loomis professionals have many years of investment experience. He reviewed Loomis' rating system and Loomis' team approach to investing. He stated that Loomis sells a bond when it believes the investment has reached its potential. Mr. Dean summarized the current status of the market environment.

Mr. McManama stated that Loomis manages two portfolios for ERS. He noted that Dan Fuss, who is from Milwaukee, manages ERS's portfolios. He indicated that Portfolio A consists of investment grade fixed income assets and Portfolio B is a conservative yield portfolio. He noted that the combined value of the portfolios is \$220 million. He reviewed the combined performance of the portfolios for 2007, noting that ERS gained 4.61%, while the ML High Yield cash earned 2.17% and the Lehman Aggregate increased 6.97%. He discussed how the first part of 2007 went smoothly until the subprime mortgage problems arose. He pointed out that the ERS portfolio does not have any subprime mortgage exposure. He stated that Loomis has produced an 11.52% annualized return on the combined portfolios since its inception on November 30, 1982.

Mr. McManama described the type of investments that Portfolio A invests in. He noted that the portfolio cannot hold more than 25% in foreign fixed income securities, any bonds below investment grade or equity securities. He also indicated that Portfolio A's benchmark is the Lehman Aggregate, which is comprised of corporates, Treasuries and mortgages. He reviewed Portfolio A's performance for 2007, noting it gained 8.05%, while the benchmark returned 6.97%. He pointed out that Portfolio A has performed very well over the past three and five year market cycles. He explained the characteristics of Portfolio A and compared them to the benchmark. He stated that average maturity and duration of Portfolio A's investments are longer than the benchmark. He noted that this strategy allows Loomis to buy deeply discounted long term bonds.

Mr. McManama explained the investment guidelines for Portfolio B. He stated that Portfolio B's benchmark is the ML High Yield Cash Pay. He indicated that the portfolio may not be invested in foreign securities that are non-U.S. dollar denominated, nor can it be invested in equity or derivative securities. He described how the portfolio must maintain an average bond rating and how the portfolio cannot invest in bonds below a certain grade. He discussed Portfolio B's performance for 2007, noting that it gained 1.88% while the benchmark gained 2.17%. He reviewed the market factors that affected Portfolio B's performance. He stated that currently there are very high spreads, which provides a good buying opportunity. He pointed out that Portfolio B has outperformed the benchmark over the three and five year market cycles. He indicated that this is very good sign considering Portfolio B outperformed an aggressive benchmark in a bull market. He summarized the characteristics of Portfolio B, noting that its maturity and duration periods are longer than the benchmark. He stated that Portfolio B contains over 16% investment grade bonds, while the benchmark does not



hold any investment grade bonds. He noted that Portfolio B's overall quality distribution is higher than the benchmark.

Mr. McManama discussed Loomis' views on the economy. He stated that the Federal Reserve recently cut the Federal Funds rate to 3% and Loomis expects the rate to decrease to 2.5% by the end of April. He opined that investors will need to accept lower returns in the near future due to a multitude of factors. He noted that the option adjusted spread has increased and become more volatile, but provides an opportunity for investment. He indicated that the option adjusted spread is also increasing for high yield U.S. corporate bonds, which makes them cheaper and more attractive for investment. He forecasted that there will be an increase in U.S. speculative grade defaults.

## 7. Question and Answer Session

The Chairman and Mr. Grady answered questions from the attendees related to pension obligation bonds, ERS performance figures, the status of the internal investigation into the practice of purchasing prior service credit, ERS's funded status, the County's contributions to ERS and the status of the Mercer lawsuit.

The Chairman explained that the Pension Board does not have control over the issuance of pension obligation bonds and that ERS performance figures are shown net of fees. Mr. Grady stated that the plan's funded ratio has increased over the past three year and that there is no risk of benefits not being paid. He indicated that the funds for benefit payments come from contributions and investments. He noted that if the County does not pay the full amount of its required contributions, the shortfall is amortized over five years. Mr. Grady stated that he cannot comment on any potential or actual litigation. In response to a question, the Chairman stated that the Pension Board does not have the authority to reduce benefits. He also indicated that the investigation of the purchase of service credit has been temporarily placed on hold.

In response to a question, Mr. Dennison stated that the current economic landscape is different than previous recessions. He indicated that the central banks are stronger than the past and are in a better position than in previous periods of economic downturn. He pointed out that once a security is sold at a loss, the loss is booked and the investor cannot get it back. He noted that an investment manager search is very important. He provided the example that a quality investment manager not investing in the poor technology stocks of the late 1990's and early 2000's ultimately saved some funds large amounts of money in the end. He stated that

Mercer may advise a fund to retain an investment manager even though it is underperforming because it believes the investment manager's management team is strong. He also discussed the difference between investment versus consumption and its overall effect on the economy.

8. Adjournment

The meeting adjourned at 11:50 a.m.

Submitted by Steven D. Huff,  
Secretary of the Pension Board